

IRS TAX TIP 2004-35

EARLY DISTRIBUTIONS FROM RETIREMENT PLANS

An early distribution from an Individual Retirement Arrangement (IRA) or a qualified retirement plan need not be a “taxing” experience, according to the IRS.

Any payment that you receive from your IRA or qualified retirement plan before you reach age 59½ is normally called an “early” or “premature” distribution. As such, these funds are subject to an additional 10 percent tax. But there are a number of exceptions to the age 59½ rule that you should investigate if you make such a withdrawal. Some of these exceptions apply only to IRAs, some only to qualified retirement plans, and some to both. IRS Publications 575, “Pensions and Annuities,” and 590, “Individual Retirement Arrangements (IRAs),” have details.

In addition to the 10 percent tax on early distributions, you will add to your regular taxable income any distributions attributable to “elective deferrals” that you contributed from your pay, your employer’s contribution and any income earned on all contributions to the account. If you made any nondeductible contributions, their portion of the distribution is not taxed, since you’ve already paid tax on this amount.

There is a way to avoid paying any tax on early distributions, however. It is called a “rollover.” Generally, a rollover is a tax-free transfer of cash or other assets from an IRA or qualified retirement plan to an eligible retirement plan. An eligible retirement plan is a traditional IRA, a qualified retirement plan, or a qualified annuity plan. You must complete the rollover within 60 days of when you received the distribution. The amount you roll over is generally taxed when the new plan pays you or your beneficiary.

If the early distribution from an employer’s plan is paid directly to you, your plan administrator will normally withhold income tax at a 20 percent rate. If you roll over the distribution to a new plan, you must replace that 20 percent of the funds that were withheld and deposit that amount in the new plan, or you will owe taxes on that amount. To avoid the inconvenience of this withholding, you can have your old plan’s administrator transfer the rollover amount directly to the new plan or to a traditional IRA.

All early distributions must be reported to the IRS. You will report tax-free rollovers on lines 15a and 16a of Form 1040 along with any taxable distributions, but you will enter on line 15b or 16b only the taxable amounts you don’t roll over. If applicable, figure the 10 percent tax or exceptions on Form 5329 and then carry any resulting tax to line 57 of Form 1040. You may also report rollovers on Form 1040A, but you must use Form 1040 if you have any distributions to which the 10 percent tax applies.

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Important tax information should be reported to you by your plan administrator on Form 1099-R. This will show the distribution amount, the taxable portion, any tax withheld, and a distribution code related to the 10 percent tax. If your early distribution is subject to the 10 percent tax and distribution code 1 is correctly shown in box 7 of your Form 1099-R, you do not have to complete Form 5329. Just multiply the taxable distribution amount you put on line 15b or 16b by 10 percent and enter the result on line 57 of Form 1040. Also, put "No" to the left of line 57 to indicate that you don't have to file Form 5329.

You may download Publications 575 and 590, along with any related forms and instructions, through "Forms and Publications" on the IRS Web site at *IRS.gov*. You may also call toll free 1-800-TAX-FORM (1-800-829-3676) to order them.

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